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"On the whole, one can say without exaggeration that the practical value of statistical research depends primarily upon the soundness of the theoretical conceptions on which it is based."

Friederich A. Hayek, Monetary Theory and The Trade Cycle.
p.39, Augustus M. Kelly, New York

HIGHLIGHTS

The message of the recent U.S. and German discount rate shifts is clear: The U.S. must do everything necessary to prompt an economic recovery; the Bundesbank is singularly focused on domestic inflation no matter the external consequences. That's bad for the dollar.

Will the recent discount rate cut finally prompt a recovery? Markets are euphorically saying yes. We doubt it. In this letter, we try to lay out the length and breadth of problems that obviate the stimulative effects of lower short-term interest rates.

Even with the recent economic disappointments in the English-speaking countries, the refrain of the forecasters remains the same: "The ingredients for a recovery are in place." Why were they wrong in the first place?

The same ingredients that disappointed last year's forecasts are still haunting the outlook this year. The forces behind the current recession are still far from over.

At present, it's a fact that private credit growth has fallen to such low growth rates that interest rate expenses are not even covered. As long as that condition lasts, it spells a continued contraction of the real economy and a worsening real estate crisis.

In many countries, especially since the mid-1980s, the fatal policy mistake has been to take a myopic view of inflation and to ignore the implications of the past debt and credit excesses.

Authorities have been fixated with product-price inflation in goods and services. Critically, they have been complacent about the unfolding asset-price inflation and the simultaneous, exploding trade deficits. In reality, the latter types of inflation are much more dangerous over the long run.

With stock markets at new highs, economists point to it as a reliable precursor of an economic upturn. That couldn't be more wrong. The stock markets, more or less, have decoupled from the economy ever since the mid-1980s.

Today's stock market speculation makes the 1920s look like kids play. We draw some distinguishing and revealing comparisons between the two periods.

The dollar should continue to weaken and the stock market remains as vulnerable as never before.

FLIGHT TO INSANITY

For world financial and currency markets, the year 1991 closed the history books with a shattering display of monetary fireworks and stock market chutzpa. The Bundesbank stunned the international markets by hiking its lending rates by a half percentage point. Just one day later, the U.S. Federal Reserve Board hit the panic button and cut its discount rate by no less than a full point. Virtually, in one stroke, the already cavernous yield gap between the two currencies in the short-term Euro markets widened to a chasm of 5.5% . . . and, that even may not be the end of it. Whatever the case, stock markets around the world celebrated.

Important, particularly for the currency markets, is that these actions convey some very clear messages: For the Bundesbank it's this: We will take care of our domestic problems whatever the consequences for our currency. The German central bank is determined to fight inflation at any cost. The Federal Reserve, on the other hand, has made it equally clear that it must do anything and everything it can to revive the ailing U.S. economy. While these policies may be at odds, they should and do have a common impact on the dollar.

POLICIES AT ODDS, COMMON EFFECT

To us, that such resolve exists in both of these cases has never been a subject of much doubt. We can imagine, though, that the two central banks, like most others, may well underrate the dollar's vulnerability to a prolonged U.S. recession and to such a wide interest gap.

Not only is the present monetary-policy clash between the dollar and the D-mark unprecedented in its fierceness, one must also bear in mind that the large American banks — above all the money-centre banks — are heavy net borrowers of short-term Euro-dollars, in amounts running into the hundreds of billions of dollars. That makes the present situation even more burdensome and unstable for the dollar and the banking system. As it is now, the ratio of the German discount rate versus the U.S. discount rate is at a record high. (See graph on the opposite page). German short rates are the highest since 1931 and U.S. short-rates are the lowest in 27 years.

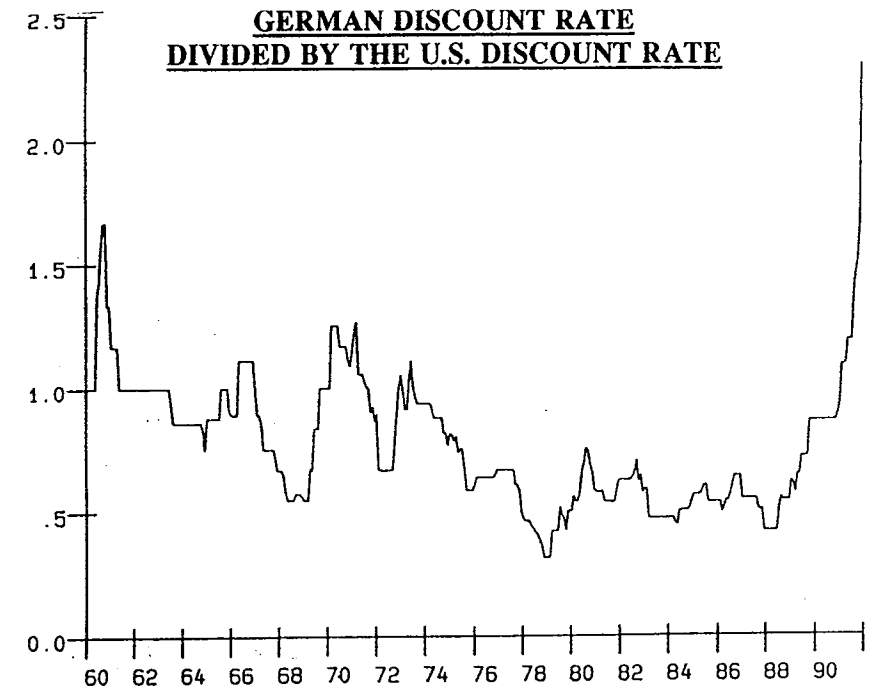
Given all that, a conundrum continues to challenge us: Just what is impelling European bankers to hold such huge sums of low-yielding, steadily-depreciating dollars? It is true that there still is a strong consensus in Europe that the U.S. economy and the dollar are on the verge of bottoming out. As such, foreigners are indoctrinated by Wall Street's bullishness. But is that an all sufficient explanation?

ANOTHER YEAR OF MISDIAGNOSIS

Humiliatingly, the course of 1991 and its year-end events have made a mockery of economic policies and the conventional economic opinion-makers in the English-speaking countries. First off, policy-makers and mainstream economists never fully understood the nature and implications of the roaring asset-price inflation that took swing after 1985. Next, they completely failed to spot the recession until well after its arrival. And latterly, to complete the string of errors, forecasters have been beating the drum on an approaching economic recovery for well over a year. The whole saga bears reviewing.

It all started with a sudden weakening of the Anglo-Saxon economies throughout the course of 1990. Since this slowdown coincided with the outbreak of the Gulf crisis, it quickly became a worldwide consensus that they were interrelated. It was alleged that a Gulf-related confidence shock caused consumers and businesses to retrench. When the war ended in February 1991, economists around the world where effusively unanimous that the U.S. economy would immediately power into a "surprisingly strong rebound" and that in so doing, would attract sharply rising capital inflows into U.S. financial markets. Not only that, the

situation was gleefully contrasted with the sorry prospects for the European economy — specifically Germany — it being weakened by the debilitating effects of unification. At the time, no one could identify any causes for a continued recession in the U.S. as well as the other English-speaking countries.



Source: International Strategy and Investment, December 23, 1991

As we've already pointed out, the course of events proved rather different. The dollar, after soaring to a high by July 1991 on nothing more than post-Gulf-war bravado, exited the year closer to its previous lows. As to the so-called recoveries, they weren't recoveries after all, but merely short pauses within prolonged economic declines.

After this rapid succession of memorable misjudgments, one should at long last expect some critical probing and reassessment. Yet, nobody, virtually nobody, discusses or even poses the question of why things went so awfully wrong. Like a broken gramophone disc, forecasters monotonously, only louder, repeat the same refrain: "All the ingredients for recovery are there. A economic rebound is only delayed." And now, with the "we mean business" discount rate cut in the U.S. (Who would dare fight the Fed in an election year?), again, virtually nobody can imagine a spirited economic recovery not taking place.

To witness, the just published report by the Organization for Economic Cooperation and Development (OECD) in Paris about the state of the world economy bearing the title Path to Recovery, starts with the sentence: "*OECD growth appears weaker in the second half of 1991 than expected, but the fundamental conditions for renewed growth at a moderate pace are in place.*"

Recently, Anthony Harris wrote in the Financial Times: "*The clearest lesson of [last] year has been that economists know next to nothing about the future.*" What's far more frightening, we would say, is that they seem to know just as much about the past. Just what are the overlooked features of the current economic scene that foiled the forecasts of the past few years? Are these factors still in force and applicable now? We think yes. We want to fully explain why.

THE SEEDS OF FURTHER DISAPPOINTMENT

It all starts with an understanding of how the credit and debt excesses of the 1980s, through their devastating effects on economic and financial structures, are leading to the depression of the 1990s just as the credit and debt excesses of the 1920s were the forerunner to the Depression of the 1930s. As well, a proper understanding of the differences between product-price and asset-price inflation is necessary, too. We don't

see any evidence of any such understanding . . . not even a flicker or an attempt.

Explanations focusing on past excesses and their eventual impact are ignored today. More or less, it has dawned upon most experts that the current recessions in the United States, Britain, Canada and Australia are not typical, brief, inventory corrections. Yet, government officials and economists obstinately talk and forecast as if it were. Having learned and experienced nothing different, and their computer models being geared to nothing else, they simply cling to their conventional, superficial beliefs and economic indicators.

THE QUEST FOR A RELIABLE LEADING INDICATOR

What about the preposterous contrast between the booming U.S. stock market and the comatose economy? The stock market, in its superior wisdom, is supposed to discount the future rather than reflect the present, lugubrious or otherwise. With stock markets at new highs, gloomy talk seems out of place. For the bullish clique, though, such a divergence between the market and economy is just infeasible. In other words, they would counsel close your eyes and blindly trust in the U.S. stock market's infallibility in anticipating the approaching economic upturn. And that approach, it seems, is about the extent of modern economics. The truth, though, is that the stock market has not been very reliable forecaster at all especially since the mid-1980s . . . but more on that later.

To us, looking at the U.S. economy's poor performance in 1990-91, we would say that the weak broad-money aggregates have been right and the buoyant stock market totally wrong. But, it is true too, that the money-economy relationship since 1985 has also defied all the rules of the game. In 1985 to 1986, exploding debt and money growth coincided with a lacklustre economy and sharply falling inflation. But soon afterwards, in 1987-89, sharply slowing money growth coincided with a strong U.S. economic rebound and accelerating inflation.

Even though the money-economy relationship has appeared tighter in 1991, a new imbroglio has been in the making recently: the growth rates among the narrow and broad money aggregates have become grossly disparate. M1, which is now surging, seems to spell impending economic recovery, while a near-vertical decline in credit and broad money growth seems to spell economic disaster. These split trends are evident in the U.S., Britain, Canada, and Australia.

Here again is an example of how most economists react to the data which doesn't fit in with their bullish picture. All of a sudden, one after the other discovers the diminishing importance of the broader money aggregates. Narrow money growth (M1) is held out as a reliable indicator of recovery even though its stable relationship to the economy just about vanished in the 1980s. So far in the 1990s, this money supply-GNP relation shows every sign of further decay. The implications of the slower growing, wider, money-aggregates (such as M2, M3, and M4) are ignored with the view the economy can get along with less money and balance sheet expansion than in the past.

TOO MANY CORRELATIONS AND NO THEORY

Today, most economists search their computers for correlations. We, on the other hand, search with logic and theory for causes and explanations. In reality, what happened in 1984-86 was that the central banks in the United States, Britain, Canada and Australia responded to slowing economic activity and falling inflation with a massive monetary easing which sparked a runaway money and credit expansion in each of these four aforementioned countries.

As money and credit ballooned as never before — without impacting GNP or the price indices (particularly, the widely-followed consumer price index) — conservative money-growth targets were dumped. Even though asset prices (real estate, stocks . . . etc.) soared, they were mistakenly ignored as irrelevant. (See Table I below for the contrasts in inflation and money an credit growth).

THE FACE OF INFLATION: UNITED STATES
(Percent, annual)

	M1	M2	DEBT	GNP	CPI
1985	12.3	8.2	13.7	6.4	3.8
1986	17.0	9.6	12.8	5.4	1.1
1987	3.5	3.5	9.3	6.7	4.4

As Mr. Lawson, Britain's Chancellor of the Exchequer, joyfully proclaims: "*The inflation rate is judge and jury.*" Nothing else seems to matter. Now, that the inflation rates (product prices) are declining in all of the recession countries, most policy-makers and economists happily conclude that this is a thoroughly healthy development. Endorsing this view, financial markets are booming as Wall Street celebrates a "New Era" of disinflation. This shallow thinking harbours some deadly oversights.

THE INFLATION FALLACY

We want to carefully point out the cardinal fallacy in this prevailing thinking about the linkage between money and the economy. Principally, in the evaluation of this relationship, the money supply is equated to GNP, the gross national product, which *only* represents the economy's entire current output of goods and services in a given period time. Herein lies the great fallacy.

Money, whether one's own or borrowed, can always buy two different categories of things. One category consists of the goods and services from current output or imports. The second kind consists of existing property, including real estate, factories, and all sorts of financial assets such as stock, bonds, insurance, savings . . . etc.

When people increase their buying of goods and services from domestic output, part of it is met by rising real output — in other words, GDP (gross domestic product) grows — and part is soaked up by higher prices in the form of the familiar product-price inflation.

If the entire increase in borrowing were spent on currently-produced goods and services, nominal GNP would rises in lock step with the money supply. But, money is also spent on buying existing assets. Buying and selling assets obviously requires the same amount of money as buying and selling an equal volume of national product. But — and this is the crucial difference — all these capital asset transactions do not affect GNP or GDP.

In reality, the money and credit supply always serves two different markets, one for current output and one for existing capital assets. Keynes used to distinguish between industrial and financial circulation. Others distinguished between income and capital circulation. Though it's impossible to measure the two monetary circuits separately, it is important to be aware of their existence.

What happened in 1985-86 was this: Given the weakened state of the real economies, a disproportionately large part of the inflationary money and credit creation in these countries went into the capital markets driving up stock and property prices, the latter being associated with huge malinvestments in commercial real estate.

As the central banks opened their money spigots wide open, debt excesses and asset-price inflation drove

each other and, for a time, were self-reinforcing. Money, though dear by historical standards, was exceedingly plentiful and cheap relative to asset price gains. Eager lenders — the banks, the S & L's, and insurance companies — accommodated eager borrowers, both consumers and corporations. It was a classic chicken and egg situation; the faster asset prices rose, the more people and corporations wanted to borrow to buy them, regardless of high interest rates. In the United States, corporations themselves contributed to the stock-price inflation through a takeover mania.

SIMILAR POLICY MISTAKES AROUND THE GLOBE

Everywhere, the fatal mistake has been to take a myopic view of inflation. Governments and central banks were single-mindedly and gravely concerned about rising price inflation in goods and services. Critically, they were sublimely unconcerned about fuelling the unfolding asset-price inflation and the simultaneous, exploding trade deficits. And since price inflation didn't flare up, the traditional early alarm systems didn't go off. There may have been little inflation reflected in GNP and the CPI, but there was roaring inflation in the stock and real restate markets flamed by a flood of excess money and credit.

The obvious fallacy lies in the habit of policy-makers and economists to relate money, credit and inflation to only one market — national output or as it is otherwise called, GNP. Had they been as keen to avoid asset-price inflation as they were to control product-price inflation, monetary officials would have been a lot more cautious. Since few, if any, understood this type of inflation and its destructive structural implications for the economy and savings, it never occurred to them that they were sowing the seeds of certain economic disaster later.

What's common to all of the four countries — the United States, Britain, Canada and Australia — is that they all experienced the greatest credit inflation ever in history. That's bad enough, but worse than that, the rest of the world was an admiring accomplice. Investors from around the globe added fuel to these incendiary hotbeds of inflation by pouring money into them. The net of it is that most of the excessive credit went into pushing up the paper value of financial and real assets and only a minor portion impacted the prices of consumer goods and services.

ASSET INFLATION BEGETS ASSET DEFLATION

No disaster was foreseen as a result of runaway asset-price inflation. On the contrary, spurred by booming stock and real estate markets, the value of wealth rose faster than ever before in these countries. While product-price inflation makes most people poorer, this inflation made many — the owners of stocks and real estate — effortlessly wealthier. What could be so bad about that? All-round there was nothing but glee and satisfaction with this purely benevolent form of inflation except for a few critical outsiders like ourselves.

While debts skyrocketed relative to consumer income and corporate cash flow, economists triumphantly pointed out that a steep rise in the value of household assets more than cancelled out the steep rise in household debt. After 1985, U.S. households enjoyed a record accumulation of wealth. On balance, net worth actually grew from $6 trillion in 1980 to $10 trillion in 1990, a stupendous gain of 65%.

Becoming so much wealthier, many people decided to save less and consume more. Soaring real estate values and easy credit (such as home equity loans) encouraged home-owners to spend and spend more borrowed money. In other words, a sizable part of the rise in consumer spending during the past years was financed by monetizing the inflationary capital gains.

To many, this type of inflation seemed to be so harmless, without losers, and one that could therefore go on indefinitely. As the 1920s should have taught, asset inflation is in reality the most treacherous and damaging types of inflation over the longer run.

ASSET DEFLATION BEGETS . . .

The most serious damage, either actual or potential, and as we're seeing now, is inflicted on the financial system and balance sheets as inflated property and collateral values plunge. Crippling capital losses running into the hundreds of billions of dollars are being shouldered by borrowers and lenders alike.

Over the last year, credit to the private sector has virtually collapsed in the four English-speaking countries we've addressed. The most crucial issue now is to gauge the implications of this credit plunge; not only for the real economies of these countries, but also for their asset markets. It should be clear that there is a direct connection between plunging credit growth and plunging real estate markets. Remember what we said earlier: A given credit and money supply has to serve two different market systems — one for current economic output and the other for capital assets. Both markets are in competition for the supply of money.

The point we want to make here, in particular, is the consequences of a continued "credit crunch" for the property markets. Obviously, property markets now are bearing the brunt of the money and credit tightness just as they were the great "beneficiaries" of the prior credit excesses. To halt the desperate scramble for liquidity and the resulting tailspin of real estate prices, what's needed is a big infusion of new liquidity. That, simply, is just not in sight.

Sliding real estate values do more than just reduce household and business net worth. Even worse, they impair the whole credit machine by destroying collateral values and the equity capital of the financial system. Loans and securities collateralized by real estate today account for about 30% of the portfolios of banks, thrifts, insurance and other financial institutions. To put it bluntly, the bad lending practices of the past years are coming home to roost.

THE DRAG OF OVERINDEBTEDNESS

Debt excesses exhaust both the lenders and the borrowers; but overindebtedness is difficult to measure. It's a condition that creeps forward only slowly initially because the of the slow effect of compound interest early in the process. Surging debt levels and debt service costs during the 1980s generally didn't exert any spending constraints because they were offset by three factors: (1) rising employment and income; (2) rising net worth (asset price inflation); (3) lavish lending in excess of the debt service requirements.

Since 1990, though, all of the above three conditions have gone into reverse. Now, the combination of high debt and tumbling real estate values reduces household net worth while, concurrently, shrinking payrolls and business profits are undercutting the income base under the debt pyramid.

High levels of debts don't hurt as long as the banks lend in excess of the debt service costs. Remember the Third World debt bubble. For nearly ten years, LDC (lesser-developed country) debt was cheerfully rolled over. Bankers around the world regarded these loans as being risk-free. As soon as the loans matured, there always was a bevy of eager bankers willing to extend new loans to repay the old ones. Then, all of a sudden in 1982, this Ponzi scheme of rescheduling debts came to a halt. Within a matter of only months, these markets were closed and the borrowers were bankrupt.

What these international bankers never bothered considering was the fact that their credits were never employed in productive use; rather they were wasted in unproductive applications. Debts had piled up without a commensurate increase in external earnings which was needed to service them. Continued debt service depended solely on new credit.

Unproductive versus productive, that's really the key issue. It's always unproductive debt that spells disaster. If the debt explosion of the 1980s had financed productive investment, it would have created future income. Instead, the record-borrowing of the 1980s has overwhelmingly mortgaged future income by financing consumption, financial speculation and malinvestments.

Apart from skyrocketing consumer debt, the debt balloon was pumped up with the hot air of LBO (leveraged buy-outs) and real estate deals. Productive credit was almost non-existent. To quote Joseph Schumpeter on this point: *"The conclusion that really follows is that the credit machine is so designed as to serve the improvement of the productive apparatus and to punish any other use."*

WHY INTEREST-RATE CUTS MAY NOT WORK

Under trying economic conditions, it is only natural for consumers to retrench, mainly by borrowing less. Result? A virtual collapse in new borrowing. Many economists like to call this the "pause that refreshes." In this wishful scenario, the consumer rebuilds his liquidity, and sooner or later will be back merrily borrowing and spending again.

Actually, this conception of ongoing reliquification and imminent recovery is one of the crucial errors in all of the "just-around-the-corner" rebound forecasts. Given worsening income and wealth conditions, the consumer's retrenchment is inevitable. But it's critical to recognize that such efforts become counterproductive when the whole community does so. It's the essence of the debt-deflation theory.

To be realistic, so far there has been no real debt liquidation except through default. Yes, consumers have sharply pared their debt growth. But, at the same time the weak economy is squeezing their income growth and home equity. So far, the U.S. consumer's finances are certainly still deteriorating.

In other words, the reduction in debt levels has not even started. Overindebtedness and the breaking of the postwar bull market in real estate prices though they may be the most visible are only part of the trouble. Equally important in the longer run, though less discussed, are other serious long-term damages to the structures of these economies.

Soaring real estate values and easy credit encouraged and allowed home-owners to spend recklessly regardless of income. What's often overlooked is that this borrowing and spending binge essentially caused grave distortions in the domestic demand, output and investment structures. These distortions as we see, were of the same type in the U.S., Britain, Canada and Australia, though, with considerable differences in degree. Overall, there occurred a massive misdirection of financial and real resources into unproductive uses. Here, are the some of the symptoms of this shift:

1. A surge in consumption ratios reflecting a collapse in private savings;
2. Large malinvestments in commercial real estate (trade, finance);
3. Record-low productive investment and even disinvestment in the manufacturing sector;
4. Record-low business profits and falling rates of return on capital.
5. Chronic external deficits due to underinvestment in manufacturing and foreign borrowing. Although

the current-account deficits have improved, they remain ominously high despite the deep recessions in these countries.

None of these fundamental barometers have yet been rectified, yet ever since the Fed slashed its discount rate by a full percentage point, optimism about the U.S. economy has been rekindled, especially so in the financial markets. Coming on the tail of all the other rate cuts, so the argument goes, this cut for sure should get the economy moving again. Nobody, though, is able to explain in some detail just how the recovery is to play out. It just seems to be taken for granted. After all, after a series of discount-rate cuts the economy always recovered before in the post-war period.

We have always stressed the unusual causes of this recession. Some are obvious, like the real estate crisis and the associated banking crises. There are the many other depressing influences we've mentioned whose impact are less visible and more difficult to assess. In this letter we've tried to portray the breadth and depth of these problems as completely as possible. Why? Because the weight of all these problems makes us rather doubtful about the final efficacy of lower short-term interest rates.

Although we may doubt, we nevertheless monitor very carefully what's happening to the money and credit aggregates, above all the latter. People who borrow, spend. Either they spend it on goods and services or on assets. At the present, it's a fact that private credit growth has declined to such low growth rates in all of the English-speaking countries that it is insuffcient to even cover interest rate costs. As long as that condition lasts, it means that new credit no longer adds to the general purchasing power. That, in turn, spells a continued contraction of the real economy. An economic recovery, no matter whether it's unbalanced or short, is only possible if the Fed succeeds in getting bank credit growing again.

CHRONICLING THE DECOUPLING OF THE STOCK MARKETS

All of this rather painstaking analysis of income, debts and balance sheets means nothing to economists who believe that the stock market is the best leading indicator of an economic upturn. That relationship may have been the case in the past under normal monetary and financial conditions. The logic of that link is that a monetary expansion invariably buoys capital markets first — most conspicuously bonds and stocks — before the economy. But what's overlooked is that empirically established correlations lose their value when underlying financial and price-cost-profit relationships change radically. New situations require new thinking, not old indicators. What's missing this time, though, is the key actor — an accelerating money and credit expansion.

For the first time in the postwar period, overall business and household liquidity is stagnant as measured by M4 or L, the broadest measure of money supply. Based on the last published statistic of October-end, M4 stood at $4.98 trillion, down from a peak of $5.01 trillion in February of 1991. To compare, in the recession year of 1980 the same aggregate rose $187 billion or 8.8%.

How, then, can the stock market rocket upward if overall liquidity is contracting? The answer seems obvious: the booming financial markets are getting their additional liquidity at the expense of a shrinking real economy. Instead of being the precursor of economic recovery, this flood of money into the financial markets is in reality the bi-product of the real economy's downturn. Yes, the bullish economists are correct when the explain the bull market in bonds and stocks as being a function of massive portfolio shifts. But what they forget to mention, though, is that other sectors of the economy are essentially being depleted of liquidity, an example of that being the real estate market.

For us, in short, the U.S. stock market's new bull run doesn't have very much significance at all. Schumpeter's comment about the stock market boom of the 1920s has always impressed us in this regard: *"Since stock prices have more degrees of freedom than other prices, and since financial markets confront a public very much more excitable and very much less intelligent than the constituent individuals are in their ordinary business pursuits, it is tempting to stress mere mass psychology . . . It is true that irrational fancy and downright foolish hopes or fears count for much in the short run [. . .] but they never prevent the real state of things from asserting itself eventually. Considerable booms can develop on a narrow basis of cash. Hence, it is not easy to see how speculation could be starved by lack of funds, though, of course new issues could."*

In short, what we see in the financial markets, is speculative froth. The credit and capital-intensive real estate market shows the true situation.

DIFFERENT STOCK MARKET THAN THE 1920s

Instinctively, comparisons with the stock market boom of the 1920s and its following crash come to mind. Then, the economic crisis started with the stock market crash. This time, the U.S. stock market is booming against the background of unprecedented economic and financial perils while another asset market, real estate, collapses. How does one reconcile these unbelievable contradictions? There can only be one conclusion: In hindsight, and cognizant of today's realities, the stock market speculation today makes the 1920s variety look like kids play.

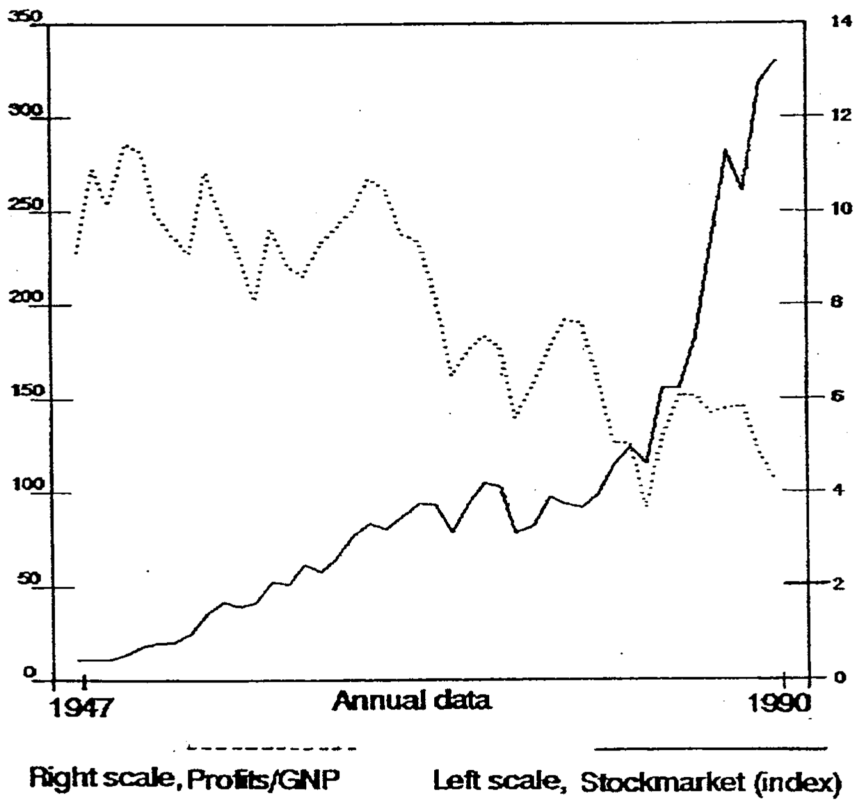
Before the stock market crashed in October 1929, the price-earnings ratio (P/E) for the New York industrial stocks had risen to 13.5X against a more traditional P/E of 10X. While business profits had risen sharply, stock prices had outrun earnings. Presently, the Dow Jones P/E ratio is 31.8X and that of the S&P 500 is levitating at 23X. Any P/E comparison between the two periods critically has to take into account the fact that long-term interest rates are much higher today — around 7-8% today versus 4.45% then.

Another major contrast, as the graph on the next page shows, is that the bull market of the 1980s and 1990s has occurred against the backdrop of a persistent downtrend in profits. Profit margins have fallen to record lows. At the same time, the dividend pay-out ratio has risen steadily to a level of 90% and more. In the 1920s, businesses retained an increasing share of earnings by lowering the dividend pay-out ratio to as low as 64%. Therefore, dividend yields today present a very deceptive picture, and even at that, the dividend yield on the S&P 500 has just fallen below 3% for only the third time this century. 1927 and 1987 were the other two times.

The really crucial differences between the speculative excesses of then and today are a function of two other sets of factors — the main players and the different techniques of speculation. In the 1920s, the main speculator was the individual who speculated on margin. When the markets finally snapped, the banks and the brokers called these margin loans leading to immediate and massive liquidations. The large losses quickly forced the big speculators to fold their cards.

Today, the stock market speculation has been driven by the professionals themselves; through the takeover mania, pensions, mutual funds and other institutionalized investment funds. The significance of that difference is that the stock market today is dominated by financially stronger players which employ leverage differently. Only recently has the individual investor finally joined the stampede. To an extent, that may explain why the speculation has become more woolly and protracted this time.

U.S. DOMESTIC PROFITS/GNP VERSUS STOCK MARKET (1947-1991)



Source: Baring Brothers/Datastream

Last but not least in the comparison is the replacement of the former margin system with new leveraging techniques available through the futures markets and other derivative markets. The proliferation of these instruments have made the stock market a much smaller cog in the financial machinery and has greatly contributed to its decoupling from the underlying economy. It also increases the stock market's potential volatility.

The most important difference between these two historical periods is the public's complacent attitude. In the 1920s, many economists and bankers were wary of the financial boom and were pointing out the dangers well ahead of time. Then, when credit expanded faster that production, it was generally regarded as being dangerously unhealthy and inflationary. For that reason, in February 1929, the Fed issued its famous warning against excessive speculative credit. In April of 1929, even the relatively bullish National City Bank of New York said this in a special circular: "*If the rate of credit increase rises above the rate or business growth, we have a condition of inflation which manifests itself in rising prices in some parts of the business structure, overconfidence, excessive speculation, and an eventual crash.*"

Today, not only is there a total lack of understanding of such fundamental considerations; there's outright glorification of stock market speculation as a sign and symbol of economic health and business prowess. Knowing a bit of history, it has always been our opinion that bankers and economists in the 1920s were more astute than their colleagues today.

CONCLUSIONS

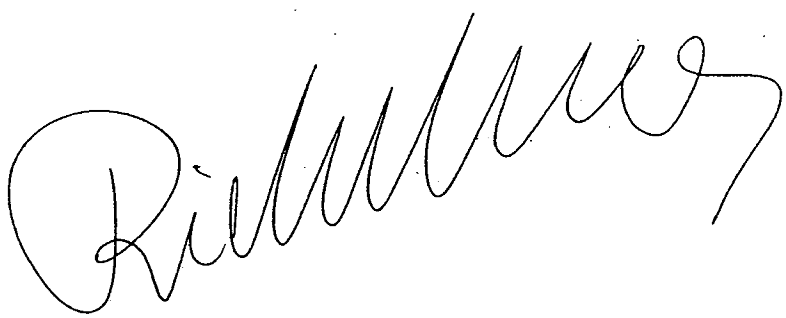
We continue to be focused on the question of whether the forces behind the current recessions have spent themselves or not. Every recession should be thought of as a period in which the economy re-adjusts from the excesses, imbalances and distortions that were caused by the prior inflationary boom. To this point, we don't see any confirming evidence that the serious maladjustments we've listed have yet been resolved.

The most necessary precondition for any recovery to get under way is the reliquification of the balance sheets of banks, businesses and consumers. In this regard, so far, there is one bright spot; businesses have sharply raised the new issue of bonds and stocks. But it is overshadowed by the big liquidity and wealth destruction in the real estate market.

In our view, the odds are increasing for a world recession. However, the global impact of this recession cuts differently. It will prove particularly difficult for the Anglo-Saxon countries. Contrastingly, Continental Europe has enjoyed an unusually long period of well-balanced and healthy growth showing striking improvements in capital formation. By these measures, most European countries are in the best shape of the last 20 years.

Once markets realize that the economies of the U.S. and the other English-speaking countries are continuing to worsen, the critical phase for the dollar and the stock markets will start in earnest.

The long-term trends are clear. The structural imbalances in the English-speaking countries are deep-rooted and long-ranging. Short-term trends may be positive for brief periods of time. However, for individual investors, these gains are extremely difficult to capture. The odds favour investing with a long-term perspective. As such, more than ever it is necessary for North American investors to broaden their frontiers and to raise their foreign investments.



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